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SUBJECT: GOS ADOPTS PRIVATIZATION STRATEGY FOR NIS

Ref: Belgrade 1013

SUMMARY

1. (U) On July 20, the Government of Serbia (GOS) approved the privatization strategy of state-owned oil company "Naftna Industrija Srbije" (NIS). The approved strategy was not the preferred option proposed by the privatization advisor consortium Merrill Lynch and Raiffeisen Investment. The approved strategy calls for privatization of the minority stake in NIS (up to 49 percent) instead of the recommended option of 51 percent majority stake (reftel). This decision sends a negative message to investors and the international community, about GOS readiness to undertake certain key structural reforms in the economy. The move also undercuts previous obligations to the IMF about its intention to sell a majority stake in the refineries. The various interests of stakeholders in NIS and the political interest of preserving the weak political coalition and majority in the Parliament are all factors in the GOS decision to pursue the alternate strategy.

NIS PRIVATIZATION STRATEGY APPROVED

2. (U) On July 25, the Strategy for NIS privatization was publicly presented at the press conference in the Ministry of Energy and Mining by Radomir Naumov, Minister of Energy; Slobodan Sokolovic, Assistant Minister; Rados Ilincic, Managing Director of Raiffeisen Investment and Scott Lewis, Director of European Energy and Power Investment Banking from Merrill Lynch.

3. (U) Minister Naumov repeated the goals of the GOS which are the terms of reference (TOR) for the privatization advisor: to privatize NIS in such a manner as to create a competitive and liberal oil market; to attract strategic partners that will invest and develop programs, introduce new technologies and management methods while respecting environmental standards; and to implement the privatization in reasonable time. Minister Naumov stressed that the GOS approved the strategy proposed by the privatization advisor and reviewed by the GOS steering committee that will oblige the GOS to enable strategic partner to obtain up to 49 percent of NIS through recapitalization without the influence of the GOS.

TWO PHASES PRIVATIZATION

4. (U) Rados Ilincic from Raiffeisen Investment presented the strategy in detail starting with four cornerstones of the strategy: the configuration of NIS, the program of capital investments, the social program and changes to the regulatory framework. Ilincic said that strategy envisaged preservation of the vertically-integrated company and the process of privatization in phases. The capital investments are expected to reach some USD 500 million in two phases with the focus on environmental protection, fuel quality and working conditions. The social program will be defined later but will not be different from any other. Redundant workers will get approximately EUR 200 per year of employment, and the shares will be at their disposal immediately with a guaranteed minimum selling price. The regulatory framework will be gradually

changed during two to four years to give the company time to prepare for competition. Sokolovic explained that changes to the Customs Law will introduce custom taxes that will be phased-out to EU levels by 2012.

15. (U) The first phase of privatization consists of two steps that will flow continuously. In the first step, the GOS will sell 25 percent of shares to the strategic partner with the money going to the budget, and in the second step the strategic partner will increase the capital of NIS by 20 percent through recapitalization of USD 250 to 300 million, which will enable it to obtain 37.5 percent of NIS. The GOS will have the same stake with around 6.7 percent belonging to NIS employees and around 18.3 percent belonging to the Privatization Register for distribution to other citizens after the entire privatization process in Serbia is finished. The strategic partner most likely will acquire all the shares from NIS employees between the two phases.

16. (U) The GOS hopes that through investments and good management the value of the company will increase after three years. At that time it will offer its shares through an initial public offer at the Belgrade Stock Exchange or some foreign stock exchange to the strategic partner. Through another recapitalization of some USD 300 million and possible buying of shares at the secondary market, the strategic investor should obtain up to 49 percent of NIS. The state will have 21 percent of shares, the Privatization Register some 15 percent and the remaining 15 percent will be freely traded on the market. In the third phase, the GOS will have the discretionary right to decide how and when it sells the rest of its shares.

MANAGEMENT CONTROL "GUARANTEED"

17. (U) The strategy emphasizes the importance of giving the strategic partner, as a future minority owner, management control from the beginning. The strategic partner will have the majority in the Managing and Executive Board of Directors, but the GOS will have certain negative or veto rights, in effect maintaining ultimate management control. The specific rights and obligations of both sides will be defined later in the sales agreement. In addition, the strategic partner will have the option of buying the petrochemical complex "Petrohemija" Pancevo, which is an independent company complementary to NIS. The tender for this company will be issued at the same time as NIS.

18. (U) Rados Ilincic from Raiffeisen stated at the press conference that the decision of whether to sell the minority or majority share of NIS was difficult and the most time-consuming for the GOS. However, he believes that the goals set forth in the TOR of the privatization advisor justify the decision to sell a minority share. Ilincic said that three years would be an optimal period for acquaintance between the GOS and the strategic partner. The minority strategy may bring a lower price for NIS, but he believes that it will be justified in the middle term. Sokolovic explained that the GOS would rather see NIS as a strong regional player that spurs growth in other Serbian companies than to merely increase revenues for the budget from the sale.

19. (SBU) Mladen Levanic from Merrill Lynch told Econoff that although two options were presented to the GOS for consideration, the advisor recommended privatization of the majority stake. The Steering Committee agreed with this recommendation (see reftel) and presented it to the GOS. However, after final consultations with members of the GOS, the Steering Committee revised its recommendation and the GOS adopted the minority stake option for the strategic partner.

LEGAL AND POLITICAL REASONS FOR ADOPTING MINORITY STRATEGY

110. (SBU) There are different explanations as to why the GOS changed its strategy to sell a minority stake to the strategic partner. Sokolovic told Econ FSN that the official explanation for the change in the strategy is that the GOS could not guarantee the majority in NIS to the strategic partner in the second phase of privatization since it is against the competitiveness principle in Article Two of the Privatization Law. Dimitrije Boarov, a local journalist, unofficially said that the GOS could not announce the tender for NIS to sell firstly the minority stake in NIS because it is against the Privatization Law. (Note: According to the current Privatization

Law, only 70 percent of the capital or property is subject to sale. However, the current law refers only to socially-owned capital, and does not apply to a state-owned company like NIS. The GOS announced earlier that state-owned companies would be privatized under special legislation).

¶11. (SBU) The better solution would have been to change the current law, but the politically-weak ruling coalition did not have sufficient votes in Parliament without the support of former Milosevic's Socialist Party of Serbia (SPS), said Boarov. The ruling coalition is heavily dependant on SPS which is against privatization in the energy sector and of state-owned land. Moreover, Boarov said that they are using these assets for private interests (private pockets) and for financing the party. Therefore the GOS adopted the Decree on privatization of state-owned companies in the energy sector on the same day that the privatization strategy was adopted. The Decree enables privatization of the minority share in state-owned companies in the energy sector. Boarov thinks that the GOS is just buying time to persuade SPS to accept changes in the Privatization Law, because avoidance of the law through the Decree is not constitutional. The Decree in general only serves to implement the law but is not the law itself. Boarov believes that there is a majority in the GOS for the privatization of NIS and particularly for the model prescribed by IMF. However, the GOS argues it was constrained in pursuing this strategy due to current political realities.

UNCLEAR MODEL OF PRIVATIZATION BAD SIGNAL TO INVESTORS

¶12. (SBU) Zorana Mihajlovic Milanovic, former energy advisor to former Deputy Prime Minister Miroljub Labus, told Econ FSN that the proposed strategy actually means delaying and slowing down of the privatization. She expressed doubts that an investor will invest huge amounts of money for a little more than 30 percent of shares in the first phase without any guarantee of the majority ownership later. She believes that the GOS has privately already made a deal with either Russian Lukoil or Hungarian MOL to become a majority owner in the future. The deal would be to share the profit but the question is where the money would go.

¶13. (SBU) Harold Hirschhofer, International Monetary Fund (IMF) resident in Serbia, told Econoff that the deviations from the strategic advisor's recommendations will adversely impact the sale. The GOS deviated in two important areas: selling a minority stake in the company and not giving the strategic partner full management control immediately by ceding negative or veto rights to the GOS. Hirschhofer believes that these deviations reduce the attractiveness of the investment and will bring a lower price.

¶14. (SBU) Hirschhofer said that GOS is breaching commitments made in the last IMF agreement. The GOS agreed to include in the terms of reference for the strategic advisor achieving the highest sales price which it did not include in the TOR with Merrill Lynch. The GOS agreed to sell majority stake in the two oil refineries which is not included in the adopted strategy. Hirschhofer said that Serbia is also breaching its fiscal commitments with the recently-announced National Investment Plan of EUR 1.1 billion. The Paris Club wrote off debt based on these commitments, and Hirschhofer sees GOS actions as a bad signal.

¶15. (U) Other experts also consider the proposed strategy as unclear. Danijel Cvjeticanin, professor at the Belgrade School of Economics, thinks that the strategy is complicated, unusual and contradictory. He thinks that it is not clear why the GOS does not want to sell the majority in NIS but is giving the management control to the strategic partner and why it is doing in phases.

Privatization Timeline

¶16. (U) The privatization advisor will prepare the tender documentation by August 2006 in order to issue a tender by October 2006 and finish the transaction at the beginning of 2007. Thus far, all of the interested companies are regional players: Hellenic Petroleum from Greece, OMV from Austria, MOL from Hungary, PKN Orlean from Poland, Lukoil from Russia and Israeli Corporation.

¶17. (SBU) This move signals GOS unwillingness to undertake certain politically key structural changes -- especially when state-owned dinosaur companies are used as financial tools of political parties and serve the private interests of the managing board members themselves. It is clear that the strategy enabling the guaranteed majority ownership in three phases was proposed as the first choice of the privatization advisor (reftel), but the GOS lacked the ability and potentially the will to pursue such a course.

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